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All the king's horses and all the king's men couldn't put Humpty together again.[1]

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It is globally accepted that inter se priority of the secured creditors should be respected as part of the liquidation waterfall. However, the Indian story has unfolded with multiple twists and turns with an unclear path ahead. This article traces this history as well as the way forward.

The Bankruptcy Law Reforms Committee ("**BLRC**") a committee set up by the Indian Finance Ministry, in its report dated November 2015, recommended that secured creditors should have first priority on realisations (from insolvency or liquidation, as applicable), a practice followed globally and in India (under the erstwhile companies law) ("**BLRC Report**"). This recommendation was adopted under the (Indian) Insolvency & Bankruptcy Code, 2016 ("**Code**"), which accorded priority to secured creditors.

While the Code sets this in clear terms, complexity in factual matrices in multiple judicial deliberations as well as subsequent statutory amendments has resulted in the *inter-se* priority amongst secured creditors taking a roller coaster ride over the years.

This paper aims to take its readers along this roller coaster ride with respect to distribution to secured creditors under insolvency and liquidation waterfalls and the road ahead proposed by the Ministry of Corporate Affairs, Government of India ("**MCA**") to the Code.[2]

With the evolving private credit and deal environment in India and borrowers becoming more mature and looking beyond public sector lending, it is essential that the liquidation waterfall for secured creditors is unambiguous and in line with global standards. In addition to providing predictability in recovery to global fund managers while assessing private credit opportunities, clarity on the liquidation waterfall will send across a positive signal to global investors on the seriousness of the Indian credit and enforcement market.

"... If a secured creditor is given the equivalent of a first priority at the time of distribution (or receives directly the proceeds of the sale of collateral), it facilitates the provision of secured credit.[3]"

Position prior to 2016

The (Indian) Companies Act, 1956 ("**1956 Act**"),[4] recognised the priority of claims of secured creditors, as senior to all other unsecured creditors (subject to *pari-passu* ranking (only) with identified workmen dues). This recognition of seniority of secured creditors' claims continued under the (Indian) Companies Act, 2013 ("**2013 Act**").[5] It was commonplace that any priority of ranking between secured creditors were respected by the liquidation waterfall both under the 1956 Act as well as the 2013 Act.[6]

In the case of *ICICI Bank versus SIDCO Leathers*,[7] the Hon. Supreme Court of India ("**SC**") upheld the priority of a secured mortgagee over the proceeds from sale of the mortgaged property relying on the provisions of the 1956 Act as well as the Transfer of Property Act, 1857.

Introduction of the code

The Code was enacted in May 2016 as a major reform for addressing the distressed debt situation in the Indian market and as part of the measures taken by the Indian Government to clean up the balance sheets of several public sector banks.

The BLRC, responsible for conceptualising the Code in its current form, in its BLRC Report, recommended that secured creditors have first ranking priority, at par (only) with capped workmen dues, and junior only to process costs, *"in order to bring the practices in India in-line with global practice, and to ensure that the objectives of the proposed Code is met."*

This recommendation was originally incorporated in Section 53 of the Code, which lays down the liquidation waterfall and provides for secured creditors to have superior ranking, *pari passu* with capped workmen dues and second only to the process costs. However, when this provision was judicially tested and as the coming paragraphs of this article would suggest, it proved to be insufficient in clarifying the *inter-se* priority of secured creditors.

Jurisprudence under the Code

In a saga of many twists and turns that captured the front pages of all business papers in India for more than a year in 2018-19, one of the major points of contention in the acquisition of Essar Steel by ArcelorMittal-Nippon Steel was the payout to Standard Chartered Bank ("**SCB**") as had been decided by the lender committee while approving the restructuring plan for Essar Steel. While SCB held security provided by Essar Steel that was considered negligible in comparison to the security held by the majority of lenders to Essar Steel, SCB contended that the restructuring plan approved by the lenders proposed an inferior payout to them as compared to other secured lenders. The basis for SCB's contention, amongst others, was a literal reading of Section 53 of the Code which did not differentiate between secured creditors on the basis of their priority or value of security.

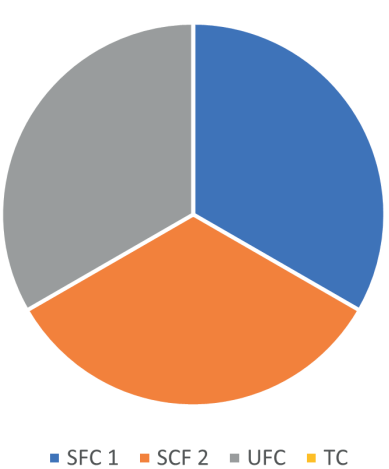
In what came as a shock to the entire lending fraternity in India, the National Company Law Appellate Tribunal ("**NCLAT**"), in *Standard Chartered Bank versus Satish Kumar Gupta, RP of Essar Steel*,[8] upheld this contention of SCB and disallowed the lenders from allocating recoveries to SCB commensurate with the value of the assets.

The NCLAT observed that financial creditors cannot be *sub-classified* as '*Secured*' or

Figure 1: (2016-2019): Illustration of distribution as per the ruling of the NCLAT in Essar Steel:

Facts:

(a) Admitted debt of secured financial creditor 1 = USD 100
(b) Admitted debt of secured financial creditor 2 = USD 200
(c) Admitted debt of unsecured financial creditor = USD 100
(d) Admitted debt of unsecured trade creditors (considered as 'operational creditor' under the Code) = USD 100
(e) Liquidation value of assets of the corporate debtor = USD 200
(f) Liquidation value of assets secured to secured creditor 1 = USD 150
(g) Liquidation value of assets secured to secured creditor 2 = USD 50
(h) Resolution plan value available for distribution: USD 240



Creditor	Share in Resolution plan value (in USD)	% of Recovery (against admitted financial debt)
Secured Financial Creditor 1	60	60%
Secured Financial Creditor 2	120	60%
Unsecured Financial Creditor	60	60%
Unsecured Trade Creditor	0	0%

'Unsecured" for the purpose of preparation of the 'Resolution Plan' by the 'Resolution Applicant'; and directed that SCB should be distributed proceeds from the resolution of the corporate debtor in the same proportion as other financial creditors, notwithstanding that the value of the assets secured to SCB was almost negligible.

Statutory amendments to stay on track

In response to the above fiasco, Section 30 of the Code was amended via the Insolvency & Bankruptcy (Amendment Act) 2019 ("**2019 Amendment**"), to include that a resolution plan under the Code must provide for the manner of distribution proposed, which may take into account "***the order of priority amongst creditors as laid down in sub-section (1) of section 53, including the priority and value of the security interest of a secured creditor.***"

Additionally, it was also specified that such a resolution plan should mandatorily "*provide for the payment of debts of financial creditors, who do not vote in favour of the resolution plan, in such manner as may be specified by the Board, which shall not be less than the amount to be paid to such creditors in accordance with sub-section (1) of section 53 in the event of a liquidation of the corporate debtor.*" It appeared that the purported anomaly in the Code had been put to rest with the 2019 Amendment and lenders having security were accorded the priority status that was originally envisaged under the Code.

This further received a stamp of authority when the NCLAT order was overturned in a landmark decision given by the SC in *Committee of Creditors of Essar Steel India Limited (through the Authorised Signatory) versus Satish Kumar Gupta & Ors*,[9] wherein it upheld the distribution to SCB basis the value of the assets secured to it as being fair and equitable and not discriminatory in nature.

The aforesaid position was further emphasised by the observations of the Insolvency Law Committee ("**ILC**") in its February 2020 report, where the ILC noted:

"*...the Code aims to promote a collective liquidation process, and towards this end, it encourages secured creditors to relinquish their security interest, by providing them second-highest priority in the recovery of their dues, as under Section 53(1)(b). Thus, they are not treated as ordinary unsecured creditors under the Code, as they would have been under the Companies Act, 1956. It was noted that, to some extent,* ***this provision intends to replicate the benefits of security even where it has been relinquished****, in order to promote overall value maximisation.*"

A new chapter unfolds post 2019

While the chapter on minority creditors (unsecured or with negligible security) challenging lender decisions was closed with the Essar Steel case, a new chapter started unfolding across various resolution processes wherein the committee of creditors overruled the minority creditor/s by providing them with recoveries pro rata to the recoveries of the other creditors, notwithstanding the unarguably more valuable security granted in favour of such creditors.[10]

In the corporate insolvency resolution process of Amit Metalliks, India Resurgence Limited raised a challenge before the SC, on the grounds, *inter-alia*, that the creditors could not have approved the resolution plan which failed to consider the priority and value of security interest of the creditors while deciding the manner of distribution to each creditor even though the legislature in its wisdom has amended Section 30(4) of the Code, requiring the committee of creditors ("**CoC**") to take into account the order of priority amongst creditors as laid down in Section 53(1) of the Code. However, the SC held that it was within the commercial wisdom of the committee of creditors to distribution resolution proceeds not taking into account the value of the assets securing a particular creditor. The SC observed that:

" *The NCLAT was, therefore, right in observing that such amendment to sub-section (4) of Section 30* ***only amplified the considerations for the Committee of Creditors while exercising its***

commercial wisdom so as to take an informed decision in regard to the viability and feasibility of resolution plan, with fairness of distribution amongst similarly situated creditors; and the business decision taken in exercise of the commercial wisdom of CoC does not call for interference unless creditors belonging to a class being similarly situated are denied fair and equitable treatment."

"... It has never been laid down that if a dissenting financial creditor is having a security available to him, he would be entitled to enforce the entirety of the security interest or to receive the entire value of the security available to him. It is but obvious that his dealing with the security interest, if occasion so arise, would be conditioned by the extent of value receivable by him."

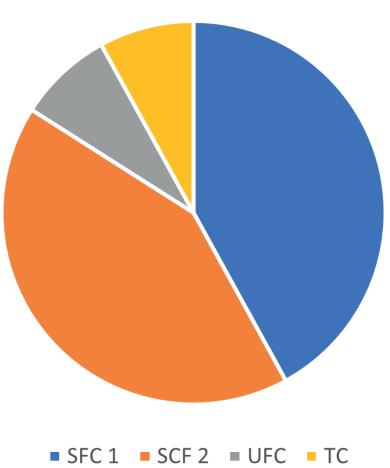
Position tabled by the MCA – final chapter in the roller coaster?

To lay to rest the aforesaid issue and to make the distribution process '*fairer and equitable to all stakeholders*', the MCA has proposed a revised waterfall in its paper on proposed changes to the Code ("**MCA Discussion Paper**") discussion,[11] summarised as follows:

Figure 2: (2022) Revised illustration – if the CoC voted to distribute pro rata (not taking into account value of security):

Creditor	Share in Resolution plan value (in USD)	% of Recovery (against admitted financial debt)
Secured Financial Creditor 1	80	80%
Secured Financial Creditor 2	160	80%
Unsecured Financial Creditor	0	0%
Unsecured Trade Creditor	0	0%

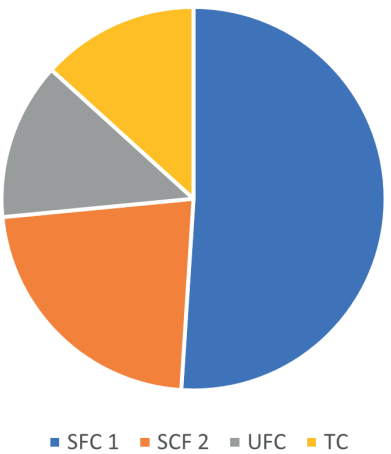
Figure 3: (2023) Illustration as per MCA Discussion Paper (Case 1)



Creditor	Share in Resolution plan value (in USD)	% of Recovery (against admitted financial debt)
Secured Financial Creditor 1	100	100%**
Secured Financial Creditor 2	88	44%**
Unsecured Financial Creditor	26	26%
Unsecured Trade Creditor	26	26%

** This is assuming that each category of secured financial creditor can recover distributions as per the assets charged to it.

Figure 4: (2023) Illustration as per MCA Discussion Paper (Case 2)



Creditor	Share in Resolution plan value (in USD)	% of Recovery (against admitted financial debt)
Secured Financial Creditor 1	71	71%**
Secured Financial Creditor 2	142	71%**
Unsecured Financial Creditor	13.5	13.5%
Unsecured Trade Creditor	13.5	13.5%

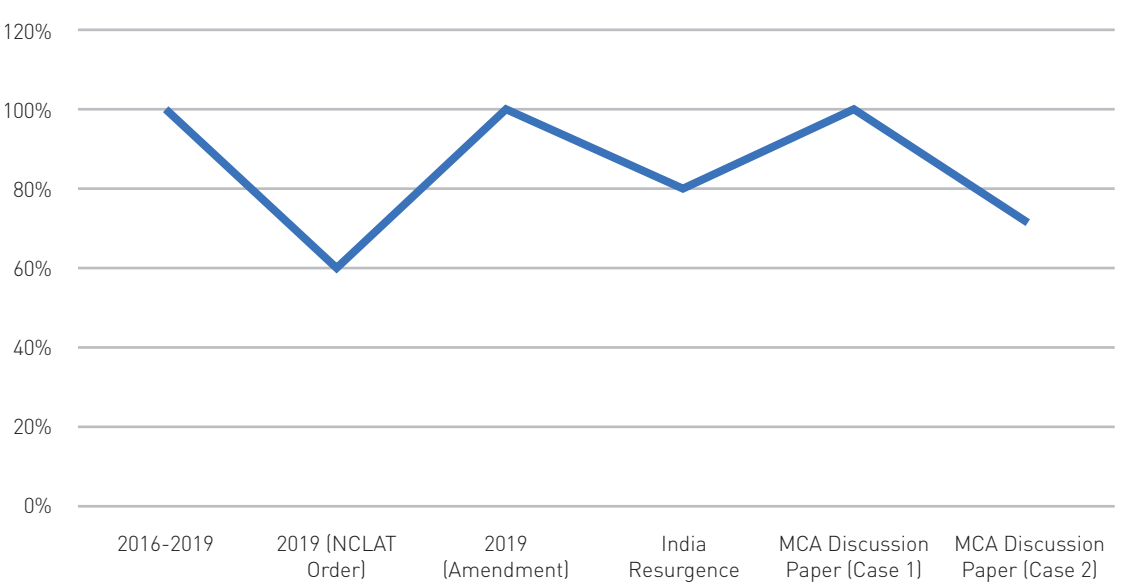
** This is assuming that secured creditors are entitled to pro rata distribution, notwithstanding the value of the assets charged to them.

(a) Secured creditors to receive proceeds up to the debtor's liquidation value for their claims in the order of priority provided under Section 53 of the Code;

(b) Amounts in surplus over the liquidation value of the debtor to be rate-ably distributed between all creditors in the ratio of their unsatisfied claims.

At this juncture, it may be relevant to double back to the matters influenced by these considerations. The UNCITRAL noted in its 2004 guidelines[12] that "*To the extent that different creditors have struck different commercial bargains with the debtor, the ranking of creditors may be justified by the desirability for the insolvency system to recognise and respect the different bargains, preserve legitimate commercial expectations, foster predictability*

Figure 5: Recoveries of Secured Financial Creditor 1



in commercial relationships and promote the equal treatment of similarly situated creditors. Establishing a clear and predictable ranking system for distribution can help to ensure that creditors are certain of their rights at the time of entering into commercial arrangements with the debtor and, in the case of secured credit, facilitate its provision."

Conclusion

The proposed amendments to the Code vide the MCA Discussion Paper in relation to the distributions to secured creditors leaves much to be desired. There is still no clarity on whether inter-se priority amongst secured creditors will be respected while running through the liquidation waterfall. It also provides no clarity on the manner of distribution when the plan value is lower than the liquidation value. While appearing to close the chapter on equitable treatment of creditors while taking a haircut, it appears to open up a proverbial pandora's box in relation to entitlement of unsecured creditors even while the entire debt of secured creditors has not been discharged.

The concern is that the proposed distribution waterfall goes against the commercial expectations evolved over years of jurisprudence; this, in turn, is expected to be a legitimate concern in the evolution of credit practices in India. The proposed distribution waterfall may also disrupt the lending market in India. This amendment may, thus, satisfy the need of the hour in putting to rest contentions raised by unsecured lenders and trade creditors on unfair treatment being meted out to them by the secured majority lenders. However, it may very well happen that this amendment leads to a fresh set of new disputes and logjams in decision making by lenders and we could be revisiting this provision when the time arrives. While this chapter ends, it would be premature to assume this to be the finale.

Notes

[1] By Avinash Subramanian, Saloni Thakkar and Simrann Venkkatesan, AZB & Partners.

[2] MCA Discussion Paper available on https://www.mca.gov.in/content/dam/mca/pdf/IBC-2016-20230118.pdf)

[3] Orderly & Effective Insolvency Procedures, Legal Department International Monetary Fund 1999 (https://www.imf.org/external/pubs/ft/orderly/)

[4] Sections 529, 529A and 530 of the (Indian) Companies Act, 1956

[5] Section 326 of the (Indian) Companies Act, 2013.

[6] The SC in the matter of ICICI Bank v. Sidco Leathers (Civil Appeal no 2332 / 2006) 27688.pdf (sci.gov.in), observed the following:

"Section 529A of the Companies Act does not ex facie contain a provision (on the aspect of priority) amongst the secured creditors and, hence, it would not be proper to read therein to things, which the Parliament did not comprehend. The subject of mortgage, apart from having been dealt with under the common law, is governed by the provisions of the Transfer of Property Act. It is also governed by the terms of the contract."

"Merely because section 529 does not specifically provide for the rights of priorities over the mortgaged assets, that, in our opinion, would not mean that the provisions of section 48 of the Transfer of Property Act in relation to a company, which has undergone liquidation, shall stand obliterated."

[7] Supra FN 6

[8] Company Appeal (AT) (Ins.) No. 242 of 2019 https://ibbi.gov.in/webadmin/

pdf/whatsnew/2019/Jul/Essar%20Steel_2019-07-04%2016:25:31.pdf

[9] CIVIL APPEAL NO. 8766-67 OF 2019 https://ibbi.gov.in/uploads/order/d46a64719856fa6a2805d731a0edaaa7.pdf

[10] Ruchi Soya (DBS Bank's super security was not taken into account) (Ruchi Soya Industries Ltd v. Union of India available on https://ibbi.gov.in/uploads/order/d24ec1f7a2f38d89a87d45a6116ae78d.pdf) and India Resurgence v. Amit Metaliks SC (Civil Appeal) 1700 / 2021 (available on https://ibbi.gov.in//uploads/order/e6da67781d1346825fbb1f398aee4b76.pdf).

[11] MCA paper on changes being considered to the Code (https://www.mca.gov.in/content/dam/mca/pdf/IBC-2016-20230118.pdf): *"it is proposed that the Code may be amended to statutorily provide an equitable scheme of distribution of proceeds received pursuant to a resolution plan(s) through a separate waterfall mechanism in the CIRP. As per this scheme, creditors will receive proceeds up to the CD's liquidation value for their claims in the order of priority provided in section 53. Any surplus over such liquidation value will be rateably distributed between all creditors in the ratio of their unsatisfied claims. Finally, any remaining amount or further surplus would be distributed to the shareholders and partners of the corporate debtor, as the case may be. It is expected that this will make the distribution process fairer and more equitable for all the stakeholders.*

[12] UNCITRAL Legislative Guide on Insolvency Law, Part Two, 2004 (https://uncitral.un.org/sites/uncitral.un.org/files/media-documents/uncitral/en/05-80722_ebook.pdf).

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